Pensions Policy Institute

PPI

What is an adequate retirement income?

Executive Summary

The Pensions Policy Institute (PPI)

We have been at the forefront of shaping evidence-based pensions policy for 20 years.

The PPI, established in 2001, is a not-for-profit educational research organisation, with no shareholders to satisfy – so our efforts are focussed on quality output rather than profit margins. **We are devoted to improving retirement outcomes.** We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. The PPI gives you the power to influence the cutting-edge of policy making. Each research report combines experience with independence to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **Independence** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

Our Vision:

Better informed policies and decisions that improve later life outcomes

We believe that better information and understanding will help lead to a better policy framework and a better provision of retirement income for all.

Our Mission:

To promote informed, evidence-based policies and decisions for financial provision in later life through independent research and analysis

We aim to be the authoritative voice on policy on pensions and the financial and economic provision in later life.

By supporting the PPI you are aligning yourself with our vision to **drive better informed policies and decisions that improve later life outcomes** and strengthening your commitment to better outcomes for all.

As we look forward now to the next 20 years, we will continue to be the trusted source of information, analysis, and impartial feedback to those with an interest in later life issues. The scale and scope of policy change creates even more need for objective and evidence-based analysis. There is still much to do, and we look forward to meeting the challenge head on.

For further information on supporting the PPI please visit our website:

www.pensionspolicyinstitute.org.uk

or contact Danielle Baker, Head of Membership & External Engagement

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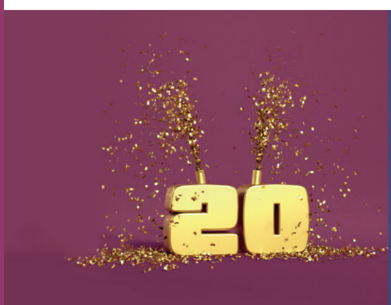

The future is ever changing,
but the PPI remains a constant
"Voice of Reason"
in the ongoing debate on the
future of retirement in the UK.

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EST. 2001

This report has been authored by:

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Nick is an independent strategy and research specialist and previous author for the PPI. Nick has 20 years' experience as a management consultant and senior industry executive in pensions and financial services with companies such as AEGON, London Life, SAGA, NPI, Price Waterhouse and Legal and General. He has run his own consultancy for 15 years specialising in research and policy work to enable consumers to achieve better outcomes in their engagement with UK financial services. His work has been mainly with public interest groups and trade bodies and much has been published and presented in research and industry forums.

Nick is a Fellow of the Chartered Insurance Institute. He holds an MBA in Insurance and Risk Management from City University Business School and a BSc from University College, Durham.

Chetan Jethwa – Policy Modeller

Chetan Jethwa joined the PPI Modelling Team in April 2018 as a Policy Modeller. He is responsible for maintaining and developing PPI models as well as producing modelling results and undertaking analysis to feed into the PPI's research.

Chetan has a BSc in Actuarial Science from the London School of Economics.

Tim Pike, Head of Modelling

Tim is the Head of Modelling of the PPI responsible for delivering the models and modelling to support the PPI's current research program. He joined the PPI in July 2015 and since then has analysed the projected implication of pension policies upon many significant groups. These have included the self-employed, women, younger generations, and the Exchequer.

Tim has worked alongside academics and other researchers on collaborative projects including WHeRL and CASPeR. These projects bring multidisciplinary research to widen the research scope to give a more complete view of the implications of interacting areas of policy.

Prior to joining the PPI Tim worked for Legal and General where he spent nearly ten years contributing to a wide variety of actuarial modelling projects, from financial reporting to annuity pricing.

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Daniela is Head of Policy Research at the Pensions Policy Institute (PPI), and leads the Policy Research team. She has a wealth of experience in conducting quantitative and qualitative research into all aspects of state and private pensions policy, writing articles for journals and national press, and presenting to a variety of domestic and international audiences, including radio and television appearances.

Daniela originally joined the PPI in 2008 and took a short break in 2012 to work as a Committee Specialist for the Work and Pensions Select Committee.

Prior to working in research and policy Daniela was a social worker with vulnerable adults and children. Daniela has an MSc in Social Policy and Planning from the London School of Economics.

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A Pensions Policy Institute report

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Sponsorship has been given to help fund the research, and does not necessarily imply agreement with, or support for, the analysis or findings from the project.

Working Closer Together

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Centre for Ageing Better

The Pensions Policy Institute (PPI) and The Centre for Ageing Better have signed a Memorandum of Understanding and have agreed to work together with a shared focus on a society where everyone enjoys their later life.

Both organisations seek to create change in policy and practice, informed by evidence.

The two organisations bring different but complementary expertise to the collaboration.
The PPI brings specialist knowledge, expertise and networks on pensions, financial planning and retirement income.
The Centre for Ageing Better brings a broader, more holistic view of later life across their four core outcomes and Priority Goals.

Executive Summary

This report explores the concept of retirement adequacy, how those approaching retirement might meet different adequacy targets, and how landscape changes may affect the way adequacy is viewed in the future. This summary covers the main points of the report and acts as the conclusion. This report concludes that a new consensus on adequacy is required, which takes into account both the need for a steady income and for capital to call on in retirement. This Government-led consensus will require buy in from employers, industry, unions and other key stakeholders in order to be successful.

A consensus on adequacy is required

The question of '**what is an adequate income in retirement?**' is fundamental to both UK pensions policy and individuals' own life savings. Without a target to aim for or a method to assess progress, people's efforts to provide financially for retirement risk being undermined by the pressures of day-to-day needs and other demands on resources. This applies both at the individual level and at the national level of the UK economy.

At the heart of this question is the multi-dimensional view of adequacy. There are a number of actors - individuals, employers, the State and society more widely. Each has their own perspective on adequacy and has, at best, partial agency over retirement savings. In these circumstances, it is not surprising that the problem of defining and, ultimately, achieving adequacy is not within the gift of any one agent alone.

A settled consensus, such as that brokered by the Pensions Commission, driven and supported by Government, and involving key stakeholders such as industry, employers and unions, is likely to be required in order to generate agreement on what adequacy target sets the boundary of acceptability given the various economic, political and societal pressures discussed.

This new consensus on adequacy will need to blend the needs for both an income stream and access to liquid savings and assets, in order to ensure that people can navigate day-to-day needs and life changes in retirement, and address how any gap between the end of career and State Pension age will and can be financed.

Ultimately, it comes down to **mitigation through at least one of the following:**

- Increasing the current rate of private pension contributions (either throughout working-life or at particular ages);
- Effecting longer working lives before retirement;
- Increasing the underpin of a higher State Pension for everybody; and
- Acceptance of a less affluent retirement than previous generations.

The UK is currently on course for a quarter of people approaching retirement being unlikely to receive even a minimum income and nearly a half failing to meet a personally acceptable level of income in retirement. Fewer than one in 10 can expect to live a comfortable life in retirement.

Of the 11 million people in the UK between the age of 50 and State Pension age:

- Around 3 million will not receive a minimum income
- Around 5 million will not receive a personally acceptable income
- Around 10 million will not receive a comfortable income

Those earning at median levels or below, women, people from BAME (Black, Asian, Minority Ethnic) groups, carers, disabled people and the self-employed are more likely to be in the groups not meeting adequacy levels throughout retirement.

Those approaching retirement with lower levels of Defined Benefit (DB) pension entitlement may also struggle to achieve adequate retirement incomes. This group is set to expand in future with the decline of DB provision in private sector workplaces, and will affect Generation X and younger Generations more than those reaching retirement in 2021.

The successful implementation of automatic enrolment, the new State Pension and the Pension Protection Fund shows what has been achieved this century and, in turn, has started to re-write a more positive narrative around pensions. The task of developing a new consensus around adequacy is certainly formidable, but not inconceivable. It needs to be based on a reasoned and shared understanding around 'what is an adequate income in retirement?'. Such a consensus is likely to be a necessary and pressing pre-condition to forming a lasting commitment to the policies required to deliver adequacy for the majority of older people in a COVID-19 impacted world.

Adequacy is about more than just the needs of the individual

Adequacy of retirement income is inherently subjective and how it is defined is determined by who makes the assessment. People require security, independence and choice in order to feel that they are achieving adequacy, and that judgement is made individually on factors that include more than just income. Furthermore, these factors change during retirement as individuals' needs change. Therefore, making judgements about retirement income adequacy in general is highly problematic.

Individuals, employers, the State and society all make judgements about adequacy and have distinct viewpoints that drive different approaches:

- **Individuals** tend to take a view based on their ability to maintain livings standards in their household from working-life through into retirement.
- **Employers** can be segmented between those who see pensions as a valuable part of their employee proposition and those who regard pensions as just a cost of employment.
- **The State** is required to provide a safety net to ensure against deprivation but is also interested in ensuring individuals are enabled to meet their own income needs in retirement and that the pensions system does this sustainably, in order to avoid people needing to fall back on means-tested benefits.
- **Society** more broadly needs to be comfortable with the level of fairness and equality allowed by the pensions system, whilst ensuring the system remains sustainable and creates a fair reward for work.

Retirement adequacy is therefore a multi-faceted concept.

There is a need to strike a balance between use of an income stream and reserve capital in retirement

Traditionally, the focus of pensions saving has been on providing an income stream rather than assets (such as housing) or reserve capital. Taking an income stream approach helps to mitigate some unhelpful behavioural effects, such as the temptation to spend on immediate rather than longer-term needs.

Though **an income stream approach** (adequacy targets set around receiving a specific level of income in retirement) is more helpful for assessing adequacy and preventing over or under spending, **a capital approach** (adequacy targets set around ensuring people reach retirement with a certain level of reserve liquid savings) may help people to meet needs which change significantly during retirement. Relying solely on an income stream in retirement limits the ability to deal with personal financial shocks. However, given the opportunity many pensioners attempt to preserve their capital, leading to lower standards of living than necessary.

Adequacy can be measured via a fixed income or proportional target approach

There are two traditional approaches to assessing adequacy which stem from these different perspectives:

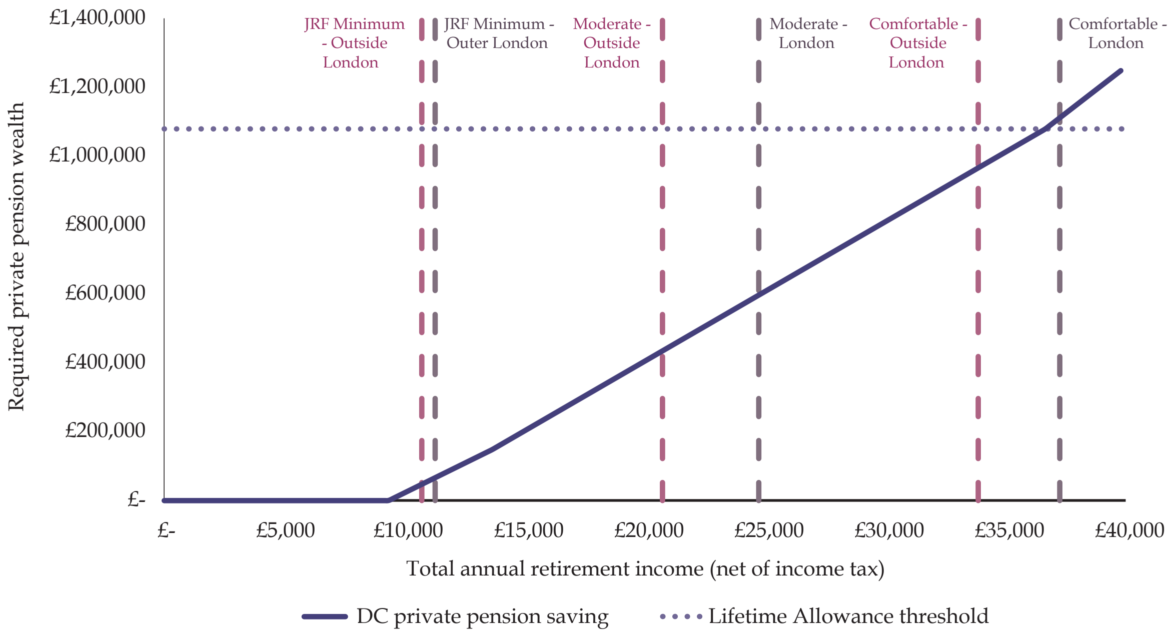
- **The fixed income target –** which has its origins in the state underpin and avoidance of deprivation, but has developed into 'basket of goods' approaches (the cost of a basket of goods and services required to meet a certain level of need or lifestyle standard). This method is used by the Joseph Rowntree Foundation (JRF) in their Minimum Income Standard (MIS) and by the Pensions and Lifetime Savings Association (PLSA) to produce their 'Moderate' and 'Comfortable' Standards. Fixed income (basket of goods) approaches produce living standard targets in terms of fixed incomes required to achieve these levels, regardless of working-life income levels.
- **The proportional income target –** which focusses on assessing subjective individual comfort. It has its origins in the view of the engaged employer and is embedded in the design of final salary pension arrangements. The Pensions Commission used this approach to make its adequacy assessments. These produced targets in the form of 'replacement rates' - the proportion by which retirement income replaces that immediately before retirement. A target replacement rate is one which allows people to replicate working-life living standards in retirement.

Substantial pension funds are required to meet the fixed income PLSA Moderate and Comfortable targets in addition to the State Pension. An individual living in a single household outside London would require a pension pot of £47,000 to secure a retirement income equal to the JRF MIS after housing costs (AHC), but would require pots of £440,000 and £966,000 to secure the PLSA Moderate and Comfortable targets respectively. This last figure rises to £1,100,00 inside London (Figure EX.1).

Figure EX.1[1]

The PLSA Moderate and Comfortable Targets require private pension funds of £440,000 – £1,100,000 for a single person household

The relationship between annual retirement income and the private pension wealth required, in addition to State Pension, to achieve the level of retirement income for an individual in a single household (2021 earnings terms)



A dual person household would require combined household funds of £480,000 to secure the 'Moderate' and £1,380,000 to secure 'Comfortable' PLSA Living Standard Targets if living outside London and £1,475,000 to secure the 'Comfortable' Target if living in Outer London.

To achieve working-life income replacement rates (proportional income targets), which allow people to replicate working-life living standards in retirement, even those at the lower quartile of earnings of £15,700 per annum will require private pension wealth of £57,000, while those at median income of £24,900 per annum will require £278,000 to meet the their target replacement rate (in addition to State Pension income and excluding use of the 25% tax-free lump sum).[2] For those on higher earnings, the lower replacement rates required by the formula means that the upper quartile earner on £37,500 per annum requires a fund of £461,000, and the 90th percentile earner at £54,000 per annum a fund of £797,000 (Figure EX.2). The right-hand axis (and purple line) represents the target working-life replacement rate. The left-hand axis shows the amount of wealth required to achieve this target.

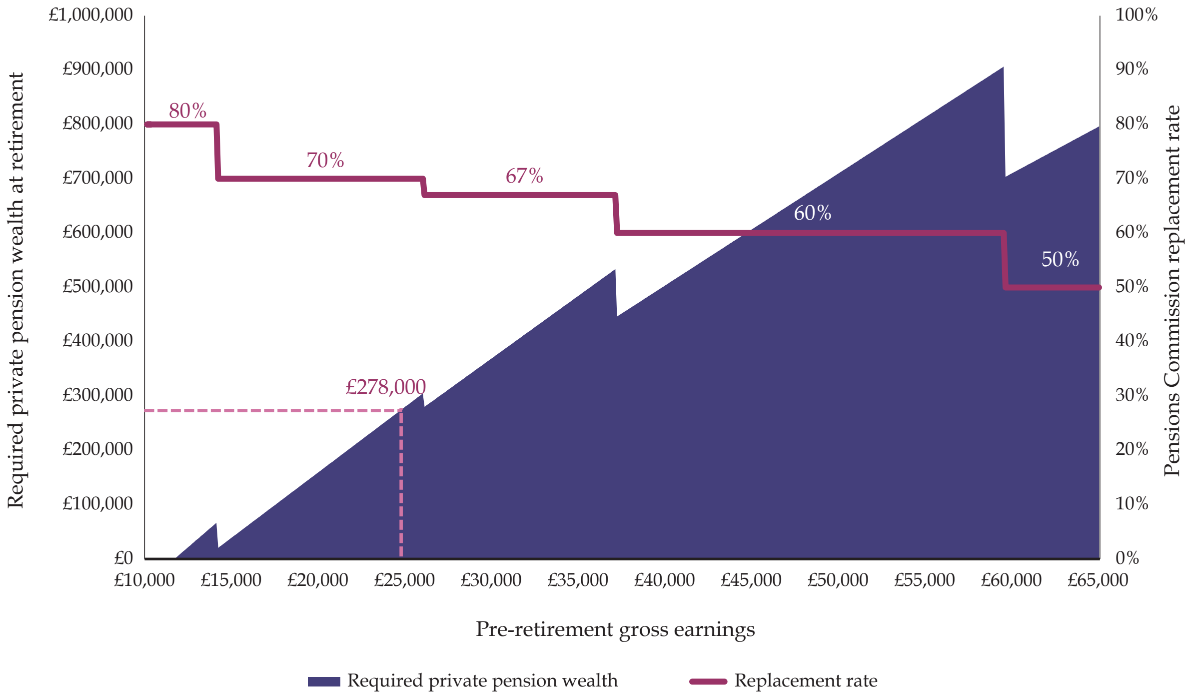
1 PPI Modelling

2 More details of the Pensions Commission formulation are provided in Chapter 2

Figure EX.2[3]

Median earners on £24,900pa will require savings of £278,000 to achieve their Pensions Commission replacement rate

Required private pension wealth to achieve a total target retirement income using Pensions Commission benchmark replacement rates (2021 earnings terms)



A significant proportion of people do not achieve adequacy if DB entitlement is excluded from the equation

If **Defined Benefit (DB)** assets are excluded from the assessments, then the proportion missing the target using State and private pension income (excluding their 25% tax-free lump sum) increases. For the JRF MIS (AHC) it increases from 26% to 40% and for the PLSA 'Moderate' from 67% to 91% and PLSA 'Comfortable' from 91% to 98%. The increase for the Pensions Commission replacement rate is from 44% to 65%. While this underscores the importance of DB pension entitlement for current pensioners, and some potential concerns for future generations who will reach retirement with lower levels of DB entitlement, future pensioners will also receive more income from Defined Contribution (DC) pensions as a result of automatic enrolment, which may make up some of the DB gap.

Those from underpensioned groups are likely to experience more difficulty achieving adequacy targets

People from underpensioned groups (women, people from BAME (Black, Asian, Minority Ethnic) groups, carers, disabled people and the self-employed) are more likely to work in low paid jobs, work part time or flexibly, be self-employed or unemployed. As a result, underpensioned people will generally find it more difficult to save into a workplace pension, other types of savings and/or to buy a house. People from these underpensioned groups may therefore find it particularly difficult to achieve basket of goods adequacy levels. They are likely to find it easier to achieve working-life replacement rate targets, however these will only reflect a low working-life income and may result in poor standards of living both during working-life and retirement.

3 PPI Modelling

Underpensioned people are likely to be fairly dependent on the level of income provided by the State through the State Pension and State benefits and will be sensitive to changes to these. People in these groups will also benefit the most from private pension policies designed to include those on low earnings or in self-employment, particularly if they involve employer contributions to schemes or Government credits without high mandatory minimum contributions from employees.

Those on median and lower earnings will struggle to achieve adequacy targets above the minimum throughout retirement

Median earners (aged 55 in 2021), retiring at age 67 and taking their DC pension savings (but not using their 25% tax-free lump sum for retirement income) will only be able to maintain a "Comfortable" Living Standard until age 70, a "Moderate" Living Standard until age 75, and working-life replacement rate until age 78, before running out of DC savings. Those earning lower, (at the 30th percentile) will not be able to maintain adequacy targets above the JRF MIS for more than a few years in retirement, (two, six and four years less respectively than the median earner).

State Pension income and DB savings are sufficient to allow them to maintain a minimum level of adequacy throughout retirement. Future generations who will have lower average levels of DB entitlement might find it harder to meet the minimum targets throughout retirement.

There is a need to review how landscape changes affect the relevance of adequacy measures

Current understanding of adequacy is framed by the history of the UK State and private pensions systems and the consensus forged following the Pensions Commission report in 2004. The key policies that set the course of pension reform for the first two decades of the 21st century were:

- the reform of the State Pension into a more generous single-tier, flat-rate new State Pension (nSP) but with later access with State Pension age (SPa) for both men and women moving up to age 66 and age 67, and
- the introduction of automatic enrolment into workplace pension schemes at a minimum contribution level of 8%.

In more than 15 years since the Pensions Commission report, there have been significant changes to the pensions landscape, as set out in Figure EX.3 – some instigated directly by pensions reform but many not. The overall impact of 21st century trends so far could be characterised more as redistributive of, rather than absolute growth in, pension provision.

Figure EX.3: an overview of recent changes to the pensions landscape

Changes to the pensions landscape

	Previous landscape	What is changing?	Impact
State Pension	State Pension age: 60 women, 65 men	State Pension age 66 for both, rising to 67 by 2028	More saving or longer working required to generate retirement income
State Pension	State Pension at lower level. Many with incomplete contribution records	Higher State Pension and Pension Credit. More qualify for full new State Pension	State Pension supports more lower paid workers. Adequacy shortfalls now more likely for median earners (DWP)
Private Pension	Majority of private and public sector pension savers in DB schemes	Move to DC saving (supported by automatic enrolment)	Similar contributions reaching 10m more workers - resulting in redistribution of pension wealth
Private Pension	DB contributions of 15% to 22%	Contributions of around 8% under automatic enrolment	Default workplace contributions reduce by around a half
Private Pension	Default is guaranteed income from DB or purchased annuity	Default is cash withdrawal	State Pension carries more of the 'load' to maintain adequacy. Private pensions provide less to retirement.
Private Pension	DB pensions designed to support household units	DC pensions designed as individual arrangements	Loss of death in service and survivor benefits but gain of inheritance potential.
Both	Income for many of 66% of working life income from a combination of private and State Pension	Target of 45-48% from State Pension and default DC contributions	Additional voluntary savings required to fill gap
Other savings & assets	Consistent increases in salaries and standard of living	Static income growth following banking crisis, impact of pandemic, likely higher levels of unemployment in future	Slipping standards of living despite full employment. Sharp rise in unemployment now predicted
Other savings & assets	Home ownership for majority, low levels of debt in retirement	Increase in renters, increase in intergenerational support, third of people taking debt into retirement	Higher demands on retirement income and immediate (less discretionary) calls on tax-free lump sum
COVID-19	Number of private pension savers increasing alongside gradual rises in contribution levels. Likelihood of fewer gaps in contribution histories.	Temporary reduction in contributions, potential long term wage scarring and increases in unemployment and ill-health	Long-term impact is uncertain, potential for reduced accrual of pension entitlement and saving and earlier calls on private pension saving

Two key issues that arise from these changes are:

- The continuing gap between the default level of automatically enrolled contributions and the level required to achieve the Pensions Commission's definition of adequacy, and
- The fundamental change in the use of pensions assets consequent to the introduction of the pension flexibilities in 2014.

These points combine with the underlying change to a DC pensions architecture (which creates individual pension pots with more risks for individuals to manage) and the overall pressure on living standards since the banking crisis, and now with COVID-19. These changes also mean that people will not receive the same level of guaranteed income stream in retirement in future, as fewer people will be receiving the majority of retirement income from a combination of DB and State Pension entitlement. These changes reflect both changes in income types and in the use of income, which mean that an adequacy approach which focusses on developing both an income stream and reserve capital will better meet the needs of future pensioners.

People are experiencing increasing additional demands on retirement income

A number of social and policy changes are increasing the demands made on assets originally saved to provide a retirement income. These include:

- A widening gap for some between leaving work and receiving the State Pension,
- Paying for rent in retirement as fewer expect to retire as owner-occupiers,
- Paying off debts carried into retirement, and
- Supporting other family members with regular financial payments, housing deposits and loans.

Marked differences in outcomes are predicted dependent on how 'adequate income' is defined

Analysis of pensions held by those aged 50-65 was projected forward to assess their ability to sustain adequacy (using State and private pension income, excluding 25% tax-free lump sums), after allowing for housing costs, under fixed and proportional income targets. The modelling does not include ongoing debt or inheritance, which will be a factor for some households. Using a range of fixed income targets:

- A **quarter** of people (around 3 million people) risk not reaching the JRF MIS
- **Single-person** households are around **four times** more likely to be below the JRF MIS
- **Low-income** households are **twice** as likely to risk inadequacy under the JRF MIS, and
- **Only a third** can expect a 'Moderate' retirement and a **one in ten** 'Comfortable' under the PLSA definitions.

But using the Pensions Commission's proportional targets:

- **Only around a half** of people can expect to maintain a **personally acceptable level of income in retirement,** and
- The challenge of maintaining acceptable incomes is greatest for the highest paid, with 77% of those in the top quintile missing the target, in contrast with only 3% of the bottom income quintile.

This analysis demonstrates clearly that the question of retirement income adequacy is multi-dimensional.

COVID-19 may have financial and behavioural consequences for adequacy as a result of wage scarring

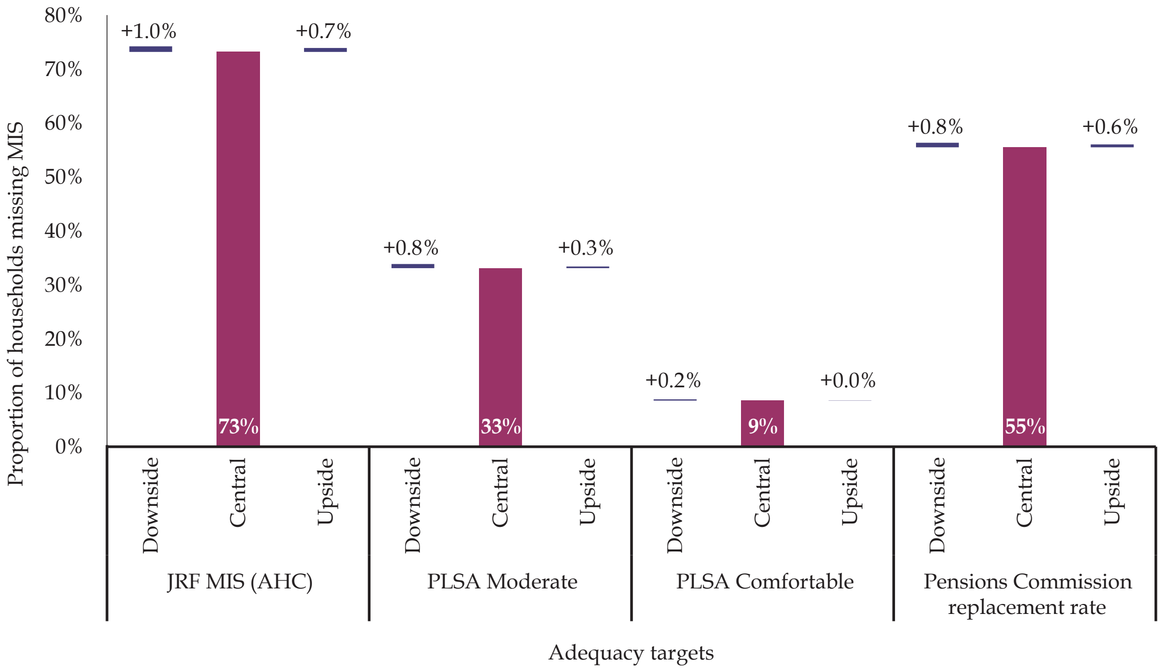
A number of subgroups are at particular risk as a result of COVID-19 impacts.

Modelling of the range of outcomes in the Office for Budget Responsibility (OBR) projections suggests that the potential of the impact of COVID-19 on pensions adequacy is noticeable but limited. The proportion of people aged 50-65 predicted to miss the JRF MIS (AHC) target decreases by 1% in both the 'upside' and 'downside' COVID-19 scenarios (because the triple lock increases pensioner income relative to earnings under these scenarios, and target levels decrease with earnings). The stabilising effect of the State Pension's 'triple lock' is exhibited in these projections (Figure EX.4)

Figure EX.4[4]

Potential COVID-19 impact on pensions adequacy is noticeable but limited

Proportion of households aged 50 to SPa in 2016/18 on target to meet adequacy targets at projected SPa by economic scenario, GB



Evidence of the behavioural impacts of COVID-19 is still emerging, but it is reasonable to think that new opportunities might arise to address public attitudes to retirement savings. It is also currently expected that, in addition to the loss of life in the short-term, the pandemic may have a negative effect on health and life expectancy in the longer-term.

People from underpensioned groups will be disadvantaged *differentially* as a result of the impact of COVID-19 on employment and job prospects. Underpensioned groups are more likely to experience labour market inequalities and so be affected by the short working, furlough and redundancies during the pandemic, as many work in the industries most impacted by the public health restrictions such as retail, hospitality and tourism, or are in low paid, part-time or irregular employment. Particular groups who are at risk include:

- Women
- People from some BAME groups
- Disabled people
- Carers
- The self-employed[5]

4 PPI Modelling; the analysis incorporates the 3% scarring of the economy forming the central assumption of the Office for Budget Responsibility (OBR) projections in November 2020

5 Wilkinson, L. *et. al.* (PPI) (2020)

Older people who lose their jobs as a result of COVID-19 may struggle to return to the labour market

The age group with the highest redundancy rate as a result of COVID-19 is those aged 50 years and over, with 12.8 thousand people being made redundant, up from 4.4 thousand at the same time in the previous year (November 2020 to January 2021).[6]

Redundancies and job losses arising from COVID-19 could have a particularly negative impact on the future earnings and pension savings levels of older people. Those who lose their jobs over age 50 are less likely to return to work than those at younger ages, and may therefore experience a long period of unemployment, meaning that their break in pension contributions may be longer than the period associated with COVID-19, but extend even up to SPa. Not only will contributions be more difficult for unemployed people over age 50, but they may also need to access their private pension savings early in order to support themselves, if unemployment continues. This further reduces the potential retirement income that they will be able to use to top up State Pension income to an adequate level. As a result, those over age 50 who lose their jobs due to COVID-19 are likely to have more trouble meeting adequacy targets in retirement than those at younger ages in similar circumstances who are likely to find it easier to return to work.

6 ONS (2021)